BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
JOHN AND ELIZA GALLOIS)

Appearances:

For Appellants: Albert Chan, Attorney at Law

For Respondent: Burl D. Lack, Chief Counsel;
Israel Rogers, Junior Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of John and Eliza Gallois to proposed assessments of additional personal income tax in the amounts of $87.41, $249.26 and $580.54 for the years 1953, 1954 and 1955, respectively.

There are a number of issues in this appeal and they will be separately discussed. Before proceeding with them, however, the following principles, applicable to all of them, should be observed. The right of a taxpayer to any deduction from gross income does not turn upon general equitable considerations but is entirely a matter of legislative grace. A taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 (78 L. Ed. 1348); Deputy v. du Pont, 308 U.S. 488 (84 L. Ed. 416).)

Since Eliza Gallois is involved in this appeal only because she filed joint returns with her husband, he alone will hereafter be referred to as "appellant."

United States Travel Expenses

Appellant resides in Palm Springs, California, but travels to San Francisco to conduct much of his income producing activities, staying at hotels in that city.

Appellant's principal source of income is his stock investments and the majority of his time is spent in managing those investments. In round figures, his adjusted gross income of $50,000 for 1954 included $15,000 in dividends and $25,000 in capital gains. In 1955, his adjusted gross income of $82,000 included $24,000 in dividends and $50,000 in capital gains. During each of those years he engaged in an average of approximately 135 separate market transactions involving some 30 different issues of stock. Even though he had an investment counselor, appellant relied on his own knowledge of financial matters and conducted his own financial affairs.

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Throughout the years 1953, 1954 and 1955, appellant was a minority shareholder in several corporations which were involved in mergers. These companies were Foremost Dairies, Golden State Dairies, El Dorado Oil, Hobbs Batteries and Gould Batteries. Appellant expended time and effort in bringing about these mergers with the hope of selling his stock after the mergers at substantially increased prices.

Appellant also owned a 15 percent stock interest in the White House, a San Francisco department store, Prior to 1955, he spent time trying to negotiate a sale or merger of that company in order to sell his stock at a profit. In 1955, he associated with Schwabacher and Company in an endeavor to merge or sell the White House, for which he was to share in a finder's fee. He continued this endeavor at least into the year 1957. The White House was ultimately sold, but not as a result of appellant's efforts and he did not receive a fee.

In June of 1954, while in San Francisco, appellant suffered from a kidney ailment and was admitted to a hospital for surgery. He left the hospital on June 2% and stayed at a hotel under the care of a nurse. During his stay there, appellant had visitors with whom he discussed financial matters. On July 27 he departed from San Francisco for further convalescence in Europe, returning to this country in October.

Appellant claimed deductions for travel in the United States during 1954 and 1955 in the amounts of $4,398.65 and $3,319.31, respectively, Of the amount claimed for 1954, $881.49 was attributable to the period of appellant's convalescence in a San Francisco hotel following surgery. The Franchise Tax Board disallowed all but $200 of the deduction for 1954 on the grounds that part of the expenses were medical costs for which appellant had already claimed the maximum deduction and that the rest of the disallowed expenses were personal or investigatory in nature or the type of expense properly deductible only by the corporations involved in the above mentioned mergers and sale. Respondent also disallowed 75 percent of the 1955 deduction on similar grounds and for lack of substantiation.

Appellant contends that he is entitled under section 17252 (formerly 17302.5) of the Revenue and Taxation Code to deduct the entire amounts claimed. That section permits the deduction of all ordinary and necessary expenses paid for the production or collection of income or for the management, conservation or maintenance of property held for the production of income,

Although appellant had visitors with whom he discussed financial matters during his convalescence in San Francisco, the evidence shows that the compelling reason for staying there was medical care. Thus, the cost of his stay may not be deducted as an expense related to the production of income. Since appellant has already taken the full medical deduction permitted by statute for 1954, he may not deduct as a medical expense the amount of $881.49 attributable to the period of his convalescence.

Any ordinary and necessary expenses incurred by appellant in the management of his investments, such as rental or safe deposit boxes, cost of investment counsel or investment services, salaries of secretaries and the like are deductible. (Cal, Admin. Code, tit. 18, reg. 13382.5; Deputy v. duPont, 308 U.S. 488 [84 L. Ed. 416]; J. P. O'Connor, T.C. Memo., Dkt. No. 36461, June 30, 1954.) Also deductible are any amounts paid in the determination of tax liability. (Rev. & Tax.. Code, Sec. 17252; Cal, Admin. Code, tit. 18, reg. 17302.5.)

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Appellant estimates that 90 percent of his time was spent in managing his stock investments and no more than 10 percent on the corporate mergers and sale.. He has submitted diaries recording his travels in and outside of the country. For the most part., the diaries are couched in general terms, referring to various corporations but without describing in detail the purpose of the travels. The diaries contain a number of references to conferences with accountants regarding taxes.

Accepting appellant's estimate that 90 percent of his time was spent in managing his stock investments, that could include many activities that were not "ordinary and necessary." Appellant has not given us sufficient evidence to judge at all precisely the amount of the expenses that were in a deductible class. In view of his extensive investments and the large number of stock transactions he engaged in, however, we are persuaded that a considerable part of his traveling was attributable to purposes which may reasonably be classed as. ordinary and necessary, such as securing information equivalent to that which might be obtained from an investment counselor. An additional portion of the expenses were deductible as related to the determination of tax liability. We conclude that deductions of $1,750 and $1,650 should be allowed for the years 1954 and 1955, respectively.

A relatively small portion of appellant's time was spent on the corporate mergers and sale. To the extent that the traveling expenses thus incurred were attributable to appellant's efforts to increase the value of his stock in the corporations involved, the expenses were neither ordinary nor proximately related to his income or property and therefore he may not deduct them. (Charles W. Nichols, T.C. Memo, Dkt. No. 83396, May 29, 1963; Deputy v. duPont, 308 U.S. 488 (84 L. Ed. 416); Low v. Nunan, 154 F.2d 261; W.P. MacMillan, 14 B.T.A. 1367.) As stated in 43 Va. L. Rev. 891, 903, "Decisions make apparent the fact that any expense which must be traced through the corporation before its effect is felt on the taxpayer's share is not proximately related.." A minor portion of the traveling expenses for the year 1955, however, were attributable to appellant's efforts to obtain a finder's fee through the sale of the White House department store. We see no reason why these should not be deductible as expenses paid for the production of income. From the evidence presented, we conclude that these expenses totaled $150 for 1955.

As an alternative to deducting the expenses connected with the mergers, appellant contends that they should be added to the basis of his stock. Since it would be impossible on the record before us to allocate the expenses to particular shares of stock, it would be fruitless to decide whether the expenses could be capitalized as appellant suggests. The facts are sufficient to indicate only that the reduction of capital gains that might result from capitalizing the expenses would not be of significant benefit to appellant for the years in question.

Club Dues, Entertainment, Telephone and Cable Expense

Appellant deducted $654.58 and $1,020.32 for 1954 and 1955, respectively, as club dues and entertainment expenses and $425.21 and $383.79 for those respective years as telephone and cable expenses. The Franchise Tax Board disallowed 50 percent of these deductions on the ground that appellant could not substantiate them.

The evidence in support of these deductions is extremely vague and totally lacking in details such as when, where and whom appellant entertained and the income producing activity to which each expense was related. In this state of the record, appellant has failed to carry his burden of proof and the action of the Franchise Tax Board in disallowing part of his deductions must be upheld. (Dauksch v. Busey, 125 F. Supp. 130; Five Star Dresses, Inc., T. C. Memo., Dkt. No. 54120, March 14, 1958; C. A. Hunt Eng'r Co., T. C. Memo., Dkt. No. 57469, Nov. 9, 1956.)

Moroccan Travel Expenses

In 1947, appellant became interested in a plan to irrigate the plains of Morocco. He joined with another American and a group of Frenchmen to form a French corporation, which will be referred to as "SERTA." Appellant had a 20 percent interest in the corporation. Following completion of engineering studies, SERTA offered to supply $60,000,000 to finance the irrigation project and the Moroccan Government accepted. In return for its services, SERTA was to receive 30 percent of the land put under irrigation and 30 percent of the stock of the water company which would operate the project.

Since $60,000,000 could not be raised from private sources in the United States, as had originally been planned, appellant sought the aid of the United States Government. He received assurances from government officials that the $60,000,000 would be made available under the "Point Four" program. The consent of the French Government was necessary, however, because Morocco was a protectorate of France.

During 1353, 1954, and 1955, appellant traveled to Europe for the combined purposes of medical care or rest cures and of seeking the French Government's consent on the Morocco plan. The consent was never secured and the project was eventually abandoned. The exact year of abandonment has not been established, but it appears that negotiations were still going on in 1956.

Appellant deducted $5,640.48 and $659.22 for travel in Europe with respect to the Moroccan plan for the years 1953 and 1954, respectively. We also claimed a deduction of $4,022.23 for European travel in 1955, 75 percent of which he has allocated to the Moroccan plan. The Franchise Tax Board disallowed the deductions connected with the plan on the ground that the expenses were only for investigation or were of a type that could have been deducted only by SERTA.

Appellant contends that these amounts are deductible under section 17206 (formerly 17306) of the Revenue and Taxation Code as losses incurred in a transaction entered into for profit. He urges that the formation of SERTA constituted such a transaction.

Section 17206 pertains to losses, not expenses. Expenses are generally deductible in the period they are incurred. Expenses of an unsuccessful transaction entered into for profit may be deducted as losses but only in the year in which the transaction is abandoned. (Charles T. Park, 1 T.C. 709; Rev. Rul. 57-418, 1957-2 Cum. Bull. 143.) We need not decide whether appellant's efforts had ripened into a transaction entered into for profit, since it does not appear that the project was abandoned during the years in question.

Appellant urges in the alternative that the Moroccan expenditures are deductible under section 17202 (formerly 17301) of the Revenue and Taxation Code as trade or business expenses.

We can find no justification for concluding that appellant was engaged in a trade or business of any kind. According to his own estimate, 90 percent of his time was spent in managing his stock investments.' The management of one's investments, however extensive, does not constitute a trade or business. (Higgins v. Commissioner, 312 U.S. 212 (85 L. Ed. 783); Commissioner v. Smith, 203 F.2d 310, cert. denied, 346 U.S. 816 (98 L. Ed. 343).)

Some cases have recognized the existence of a trade or business of promoting business enterprises, but the authority of such cases is "applicable only to the exceptional situations where the taxpayer's activities in promoting, financing, managing, and making loans to a number of corporations have been regarded as so extensive as to constitute a business separate and distinct from the business carried on by the corporations themselves."; (Dominick J. Salomone, 27 T.C. 663; S. D. Ferguson, 28 T.C. 432. See also A. Kingsley Ferguson, 16 T.C. 1248; Jean U. Koree, 40 T.C. 961.) And, regardless of their extent, services rendered by a stockholder on behalf of any number of corporations cannot constitute a trade or business of the stockholder unless they are rendered for a fee or some return other than an increase in the value of his stock-holdings or in his dividends. (Whipple v. Commissioner, 373 U.S. 193 (10 L. Ed. 288).) The only activities by appellant which could possibly qualify are his efforts to obtain fees through the sale of a department store (previously discussed) and a manufacturing plan (hereafter discussed). Because of their very limited scope, however, these activities must be regarded as isolated endeavors rather than as a trade or business.

Moreover, for the same reasons that appellant could not deduct the merger expenses considered earlier in this opinion, he cannot deduct the expenses relating to SERTA, as expenses paid for the production of income or the management of property held for the production of income.

Yugoslavian Travel Expenses

In 1954 or 1955, appellant was asked to arrange financing for a rubber tire factory in Yugoslavia. He learned that the General Tire and Rubber Company had a rubber plant located in Israel which it wished to sell. Appellant arranged to share in a 9 percent broker's commission if he consummated a sale of the plant to Yugoslavia.

In 1955, while appellant was in Europe for medical purposes and to work on the Morocco project, he went to Yugoslavia to negotiate a sale of the rubber plant. His efforts were unsuccessful and he eventually abandoned the undertaking. We do not know when the abandonment occurred, but it appears from the evidence presented that negotiations were continuing in 1956.

Of the expenses claimed by appellant for European travel in 1955, he has attributed approximately $1,000 to the Yugoslavian project. The Franchise Tax Board disallowed this deduction on the grounds that the activities were only investigatory and were not in the course of a trade or business.

Consistently with our conclusion as to appellant's expenses incurred to obtain a finder's fee, through a sale of the White House department store, we conclude that the expenses incurred to obtain a commission on the sale of the rubber plant are deductible as expenses paid for the production of income. The amount of these expenses, $1,000, is not in dispute.

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Attorney's Fee

In 1954, Vasili Romanoff asked appellant to advance money to sue for misuse of Romanoff's name in connection with the sale of Romanoff Vodka. In return, he agreed to give appellant 25 percent of any damages recovered. Appellant paid an attorney $750 to determine the possibility of winning the suit. Romanoff's plan was rejected when the attorney submitted an unfavorable report.

The legal fee of $750 was deducted by appellant for the year 1954 and the deduction was disallowed by the Franchise Tax Board.

Appellant contends that the fee is deductible under section 17206 as a loss from a transaction entered into for profit. The unavoidable answer to this claim is that appellant did not enter into the transaction; he incurred the legal fee for expert assistance in determining whether to do so. Such expenditures are not deductible. (Robert Lyons Hague, 24 B.T.A. 288.)

Appellant also contends that the legal fee is deductible under section 17202 as an ordinary and necessary expense of one of the deals it was his business to promote. We have already concluded that appellant was not engaged in a business. He has offered no evidence that he was in the loan business or that he engaged in a regular course of financing damage suits. Since the expense was not related to a business, appellant's contention cannot be sustained.

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of John and Eliza Gallois to proposed assessments of additional personal income tax in the amounts of $87.41, $249.26 and $580.54 for the years 1953, 1954 and 1955, respectively, be and the same is hereby modified in that deductions are to be allowed in accordance with the opinion on file herein.

Done at Sacramento, California, this 10th day of December, 1963, by the State Board of Equalization.

John W. Lynch, Chairman

Geo. R. Reilly, Member

Paul R. Leake, Member

Richard Nevins, Member

ATTEST: H.F. Freeman, Secretary

______________________, Member